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Market comment for the week of March 30, 2018

Transitions

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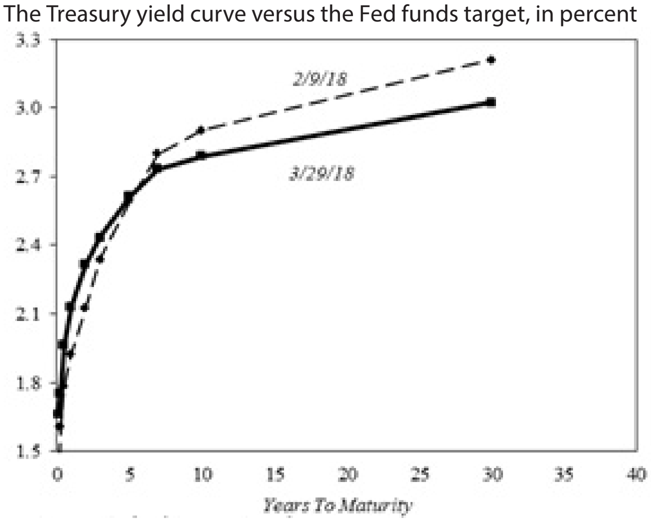
More questions than answers in a bumpy, pre-Easter ride. The stock market's happy ending to a bumpy, pre-holiday ride broke a two-week losing streak, nonetheless leaving many with an empty feeling heading into the long holiday weekend. Investors still had to contend with the S&P 500's first back-to-back monthly decline in total return since the turn of the year in 2016 and its first quarterly loss since July-September 2015. Even with Thursday's rebound, the benchmark ended the week more than 5% below its most recent, March 9 high, just over half way to another correction. Moreover, unsettled market conditions were apparent from the S&P 500's realized volatility above its average during the turbulence of the past two months and more than double its longer-term norm of the past five years.

Market turbulence likely was the driving force behind a third straight weekly rally in safe-haven bonds, leaving the benchmark, 10-year Treasury yield at an early-February low in a further, unusual bull-market flattening of the Treasury yield curve in which falling bond yields converge with rising, policy-sensitive shorter-term rates. That gap narrowed to a new 2007 low, adding to ongoing pressure from increased deficit financing skewed toward Treasury bills. Should flight-driven demand and deficit-driven supply prove more important interest drivers than a less sanguine economic outlook—signaled by investor inflation expectations at a mid-February low and widening quality spreads, particularly in the high-yield market—then the heightened risk of an inverted yield curve (in which short rates rise above those of longer-term securities) could pose less than the usual threat to the economic outlook.

Will a "bull-market flattening" of the Treasury yield give new meaning to a curve "inversion?"

The Treasury yield curve versus the Fed funds target, in percent



Source: Federal Reserve Board, as of 3/29/18.

Lastly, investors still are grappling with several unusual correlations adding to uncertainties over what is driving the market. Opposing moves, or negative correlation, between stock and bond prices, though common when earnings growth late in a growth cycle outweighs pressure on valuations from rising interest rates in lifting the market, is coming now from stock-market declines shrugging off lower yields and still-solid earnings growth. The dollar largely has uncoupled from interest-rate changes, as well, with the two moving in opposite directions despite a reversal of high and rising hedging costs disrupting the link in recent months. Likewise, interest rates have unhinged from inflation recently, keying, instead, on investor angst over policy, political, and economic uncertainties, lowering investors' long-term inflation expectations despite worries over potential price pressure from trade protectionism and late-cycle fiscal stimulus.

Still, there was cause for optimism over the market's ability to build on Thursday's gains when investors return from the long Easter weekend. For starters, last week's broad, deep rally, across all 11 S&P 500 sectors and all but 10 of its 125 constituent industry groups, could be taken as a sign of lingering confidence in the market's underlying strength. Unexpected interest-rate declines have allowed dark-horse, interest-sensitive sectors, paced by utilities and including financially engineered stocks (including spin-offs, takeover targets, and other debt-dependent, restructuring situations) to outperform the S&P 500 during much of a difficult February and March. Underpinning confidence in stocks has been an increasingly upbeat earnings outlook, countering warning signs in the bond market, lifting year-on-year growth to the upper teens for the first quarter and for the year as a whole. Tech's leading-edge strength in the end-of-week rebound raised hopes for continued support to overall S&P 500 gains from this dominant market sector—based on large tech's ability to ride out regulatory and other threats with solid earnings growth and dominant market positions—critical to passive investment returns tied to overall benchmark performance. And regardless of the reasons, lower interest rates have combined with the market's recent setback and still-solid earnings growth to leave relative stock versus bond valuations at their most attractive for stocks since November 2016, relative to the long-term norm.

The market's next big test could be its ability to weather less accommodative financial conditions, as the Fed walks the market back from ample liquidity of the past decade. Stocks will enjoy a seasonal tailwind in April, a month historically averaging above-average returns and below average volatility since 1960 (ahead of the notorious May-November period of market under-performance). Financial stress indexes still are only modestly less easy than they were a few weeks ago, supportive enough room for the latest boom in takeover activity and for a recent rebound in sub-prime mortgage-backed securities—

both providing added evidence of market exuberance and confidence that a sea change in the investment environment isn't likely soon.

Investor optimism risks becoming a headache for the Fed in its effort to minimize market volatility as it brings policy-linked interest rates back to a level consistent with economic growth and inflation fundamentals. Investor complacency over the inflation outlook may be a by-product of prolonged disinflation capped by last year's surprising retreat, contributing to unexpected yield declines that leave the market vulnerable to abrupt changes in inflation expectations or to the Fed's rate normalization as increases affect economic activity. Adding to the risk of adjustment to future policy moves are financial-market stresses and strains created by the response to years of subdued inflation and to aggressive Fed stimulus, exposing the asset markets to strains serious enough to affect both the cost and availability of credit.

The economy's nod toward stocks. Last week's batch of mixed, but reasonably encouraging, data built on earlier signs of strengthening growth from a weak start to the year; good news for the earnings outlook supporting stocks but worrisome for a recent bond rally at risk of becoming over-extended. Signaling an economy still on the upswing was a second straight rise in the Citigroup Economic Surprise Index, measuring actual against expected strength in the latest data reports, and an upward revision to at least one real-time growth estimate for the first quarter to nearly 2.5% from a sub-2% consensus just a few days ago. Soft spots in the data lent support to the bond market's cautious outlook for the economy, embodied in recent interest-rate declines. For starters, inventory building, not underlying demand, was behind much of the upward revision to estimated GDP growth, providing a temporary lift to manufacturing that already showed signs of fading with regional purchasing-manager reports for March. An even bigger blow came from a further slowing of consumer-spending growth over the latest three months, to a rate of less than half a percent.

For every data soft spot there was a silver lining or offsetting strength, however. The threat to future growth from any reversal of inventory building contributes to an improved foreign trade deficit by dampening import growth, even as it weighs on manufacturing. And consumer spending's drivers point toward improvement soon, including solid growth of inflation-adjusted incomes (or purchasing power), an increase in the saving rate to a six-month high, from separate reports showing still-elevated consumer-confidence levels, and from an S&P/Case-Shiller report showing January home prices with wealth-building increases still running well ahead of inflation. An added hurdle for bonds has come from accelerated core, or underlying, three-month inflation measured by the so-called PCE deflator (the Fed's official target index) to a six-year high in an almost uninterrupted string of increases dating back to May 2017.

"Core" inflations's near-steady rise past the Fed's official target rate unnoticed by investors

The Treasury yield curve versus the Fed funds target, in percent

Source: U.S. Commerce Department, as of 3/29/18.

Looking ahead, investors will be keying on Friday's March jobs report and economic outlook speech by Fed Chair Powell. The warm-up to the end-of-week main events will be top-tier purchasing-manager reports on March manufacturing and non-manufacturing activity in a reasonably full, evenly distributed data calendar. The Powell speech, and the subsequent Q&A period, likely will hone in on Powell's current thinking on the outlook for economic growth, amid recent soft spots in the data, and on inflation implications for clues to the frequency of rate hikes by the Fed this year. Upcoming reports, including February factory orders and construction spending, likely will add to early evidence of a growth revival. Investors will have to content themselves with Friday's March report on still-subdued hourly wage inflation for fresh hard evidence on inflation, ahead of the key price reports the following week.